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IN THE

Supreme Court of the United States

OCTOBER TERM, 1944

No. 534

ESTATE OF HENRY W. PUTNAM; GUARANTY
TRUST COMPANY OF NEW YORK, EXECUTOR,
Petitioner.

against

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED
STATES CIRCUIT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER

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October 31, 1944

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REPLY BRIEF FOR PETITIONER

**THE QUESTION PRESENTED BY THE PETITION IS OF
SUBSTANTIAL IMPORTANCE AND IS IN CONFLICT WITH
THE DECISION OF THE THIRD CIRCUIT IN THE *TAR
PRODUCTS* CASE.**

The decision in this case is in conflict with the decision of the Third Circuit Court of Appeals in the *Tar Products* case, 130 F. (2d) 866, and presents a question which is of substantial importance.¹

¹Issue is taken with one statement of fact made in the respondent's brief (p. 12) where it is said, " * * * if all other factors remained equal, the mere declaration of the dividend would have increased the market price for decedent's stock by the amount of the dividend." The declaration of a dividend usually has no effect on the market price of stock, as can be readily verified by examination of the quotations of the stock of principal corporations on the date of declaration. The declaration of a dividend is merely the transfer of corporate funds from one pocket to another. Before the divi-

If the decedent in the instant case had not died on March 30, 1938, but had on that date made an *inter vivos* transfer of the shares of stock in question to other persons, he clearly would not, under the rule of the *Tar Products* case, have been taxable upon the dividends subsequently paid to the holders of such stock, regardless of his basis of accounting. This would not have been true of the items of income involved in the *Enright* case, 312 U. S. 636, the principal one being earnings of the decedent which would have been taxable to him even if transferred *inter vivos*. *Lucas v. Earl*, 281 U. S. 111.

The *Tar Products* case, as stated by the respondent on page 7 of his brief, established that a dividend becomes income to a cash and an accrual basis taxpayer at the same

dend is declared, the stockholder is the owner of his *pro rata* share of the net worth of the corporation; after the dividend is declared, he owns no more and no less, the only difference being that the directors have decided that a portion of the assets shall be set apart and distributed to the shareholders at a later date (the payment date).

However, the situation is quite different on the record date. The universal rule of stock exchanges is that sales before the record date include the dividend and sales after the record date do not. On the record date, or the day before, to allow purchasers time to obtain delivery and make transfer on the books of the corporation, the stock sells ex-dividend. On that date, other factors being equal, the price of the stock will drop from the price of the previous day by the exact amount of the dividend. That can be verified by reference to the quotations of any leading stock on the ex-dividend day and the previous day. The stock quotation tables do not show that drop as a decrease. For instance, if the stock closed at 100 one day and closed the next day, ex a dividend of \$5, at 95, the quotations would set forth a net change of zero. That can be verified by reference to any newspaper or other table of quotations.

time, i.e., not sooner than the payment date, and that both types of taxpayers are subject to the same criteria. Accordingly, the dividend is the income of the *transferee* of stock prior to the record date, and can never under any circumstances or on any basis of accounting be the income of the *transferor*.

The Circuit Court of Appeals for the Second Circuit in the instant case held that because the transfer of the stock from the decedent on March 30, 1938, was by reason of his death rather than by means of an *inter vivos* transfer, the dividends upon the stock suddenly became an item of income to him under Section 42. But Section 42 admittedly set up no new concept of income.

However, the respondent's position must be that the word "income" itself has a different meaning in Section 42 than elsewhere. And so, at pp. 6-7 of respondent's brief, the *Tar Products* case is sought to be distinguished on the ground that it applied a regulation:

"providing that a taxable distribution by a corporation should be included in the gross income of the distributees when the cash or other property is 'un-qualifiedly made subject to their demands'". [Italics ours]

But that is a definition of when a dividend becomes "income" for Federal income ~~tax~~ purposes. Neatly illustrative of the same point is foot-note 6 (Resp. br. p. 8):

"Section 115(a) of the Revenue Act of 1938, referred to by petitioner (pet. 13, 17), simply defines a dividend for income tax purposes". [Italics ours]

Section 42, first enacted in the Revenue Act of 1934, did not purport to set up any new concept of income ("for

income tax purposes"). As stated on page 5 of respondent's brief, its object was to require the inclusion "in the income" of a deceased taxpayer of amounts which have accrued up to the date of the decedent's death "regardless of the fact that the decedent may have kept his books on the cash basis." Presumably Section 42 has no application to a decedent on the accrual basis of accounting, and in the case of a cash basis decedent, does not purport to tax anything which is not the income of the decedent, *i.e.*, items which would be the income of the Estate, on all bases of accounting—whether cash or accrual.²

Under the rule of the *Tar Products* case the executors would be taxable upon the dividend, since it was their income.³ Conversely, the *Tar Products* case makes it clear that the dividends were not the income of the decedent.

It appears to be a fact that the Federal income tax laws have been in force for over thirty years without there being an authoritative decision by this Court as to when a dividend accrues. So far as we know, the *Tar Products* case is the only Circuit Court of Appeals case on the question (beside the instant case) which proceeds on the theory that a

²The Section taxes "amounts" accrued up to the date of death, and the Committee Reports cited in the Appendix to the Petition show that the expression means amounts "of income". No contention has ever been made that amounts which were not the decedent's income, such as gifts, would be taxable to him under Section 42.

³As pointed out on p. 14 of Petitioner's brief, *Bach v. Rothensies*, 124 F. (2d) 306, decided by the Third Circuit about a year before the *Tar Products* case, did not present the question of when a dividend accrued. It was assumed there that the dividends in question had accrued to the trustee-holder of the stock.

uniform Federal rule is controlling; and it was not decided until 1942.

The decisions of the Fourth and Fifth Circuits, cited at page 8 of respondent's brief and at page 15 of petitioner's brief, both proceed on the erroneous theory that State law governs,⁴ and hence are inconsistent in their rationale both with the decision below and with the *Tar Products* case. The confusion among the Circuits is evident from a reading of their opinions. Moreover, none of the cases involving decedents, except the instant case, has indicated that a dividend accrued differently for a decedent than for anyone else. If there be any reason for such a rule, it has yet to be stated.

It is respectfully submitted that this Court should grant the petition for certiorari and thereby settle the question whether a dividend can be income to taxpayers (regardless of the method of accounting to be used and regardless of the law of the State of incorporation) prior to the time that such dividend is, in the language of the Treasury Regulations, "unqualifiedly made subject to their demands".

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⁴The respondent's brief shows the same confusion, citing numerous State cases as to when a dividend becomes a debt, etc. (pp. 10-11). The State rules are not uniform, as shown by the Tax Court decision in this case.